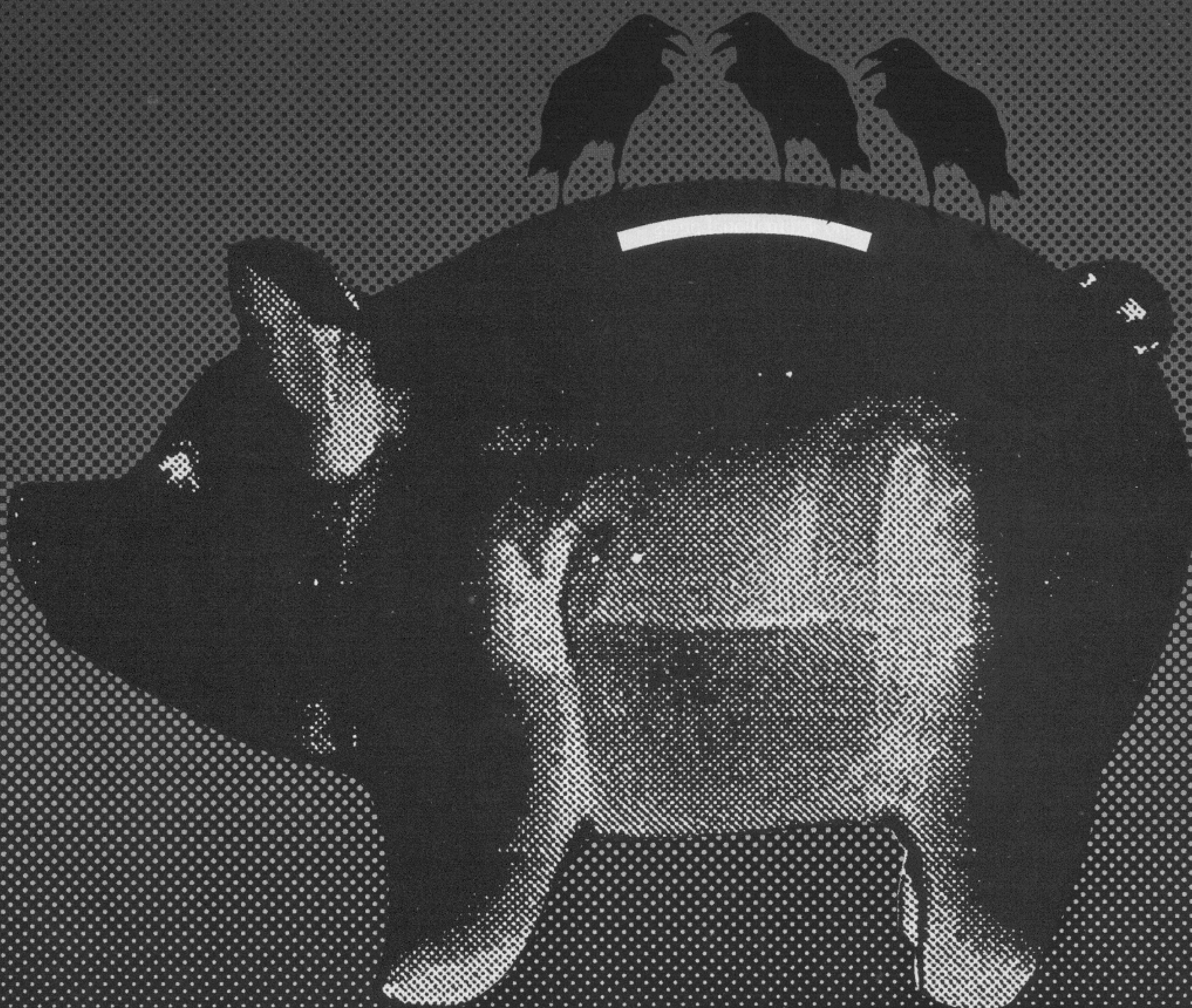
The Economist

After the chaos

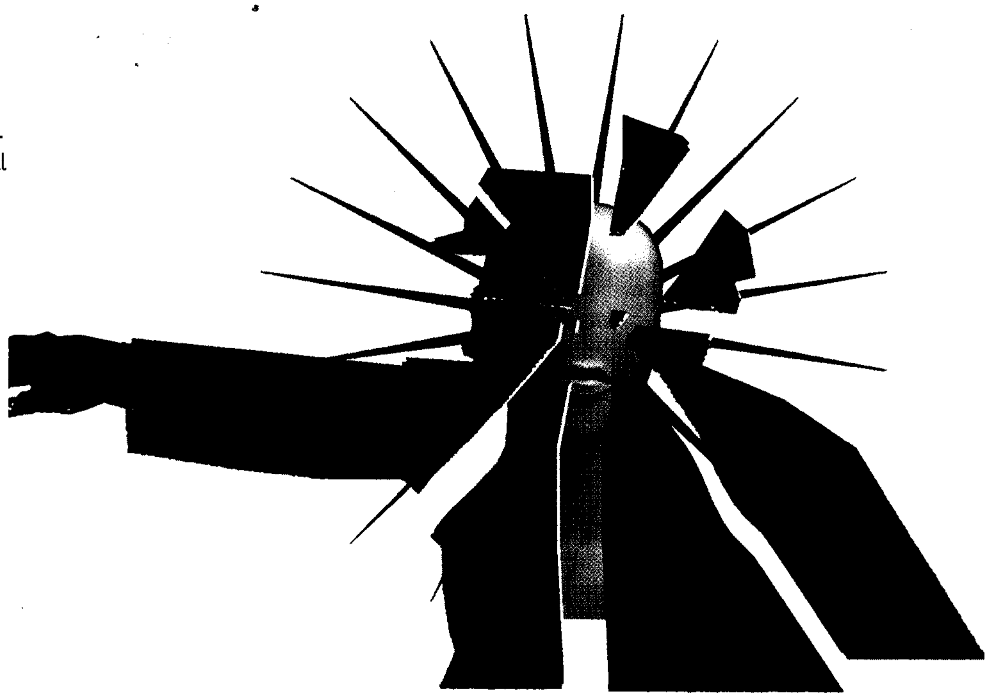
A survey of finance in Central Europe | September 14th 2002



Also in this section

Acknowledgments and sources
As well as those mentioned in the text, the author would like to thank Vivien Ashton, Peter Akos Bod, Richard Evans, Adrien Firneisz, Bridget Gandy, Claire Gouzouli, Rick Helsby, György Jaksity, Ralph and Jacci Johnson, Csaba Molnar, Les Nemethy, Ludek Niedermayer, David Nussbaum, Madjid Pajic, Nick van den Praag, Antoni Reczek, Henry Russell, Laszlo Sardi, Stefan Varfalvi, Anna Wolek, Nikola Zivanovic.

The following sources proved particularly useful: "Financial Transition in Europe and Central Asia", World Bank, 2001, especially chapter 3 by Lajos Bokros; "The Financial Integration of an Enlarged EU: Banking and Capital Markets", European Investment Bank, 2002; "Transition Report 1999", EBRD; "Transition report update", EBRD, May 2002; "Post-Communist Transition: Some Lessons", by Leszek Balcerowicz, Wincott lecture published by The Institute of Economic Affairs and Profile Books, 2002; Fitch Ratings' regular country reports on banking systems.



To prepare for accession to the European Union, Central European countries need to speed up reform of their financial sectors. But old habits die hard, writes David Shirreff

"NEVER ask a man where he made his first million," advises a stockbroker in Prague. Ten years of chaos in Central Europe (here defined as the Czech Republic, Hungary, Poland, Slovakia and Slovenia) and points east, as a dozen countries ripped up communism in favour of market economics, allowed many opportunists to get rich quick. Some did so honestly; many more cheated, bribed and stole from the state or small investors, using conniving banks as a source of everlasting loans and a place to wash their money.

That era is coming to an end, at least in the more advanced countries. Emerging from the chaos are new structures that are beginning to resemble the financial systems in Western Europe, complete with banks (mostly foreign-owned), stockmarkets, mortgages and pension funds, bank supervisors, securities commissions, property laws and governance codes.

In this brave new world, why question too closely how some people, many of them now ministers, top managers and pillars of society, made their early fortune? It makes sense only if they are still up to their old tricks. When corruption persists at the top, it percolates throughout the economy: people do not trust their leaders; they hide their money; they expect to pay and receive bribes; and banks do not trust their customers. To some extent that culture lingers on, even in Poland, Hungary and the Czech Republic, soon to become members of the European Union.

But nowadays the prospect of EU accession is prompting even corrupt leaders to pay more attention to reform. Ten countries selected for the first wave are racing to complete the requirements laid out in 31 "chapters", which include institutional reform, new laws, new tax regimes and anti-corruption measures. Hopes of accession, and fears of being bumped off the list, are concentrating minds.

Some former ministers and company bosses who lined their pockets in Poland and Serbia are now in jail. Many more of those formerly on the take are walking free. But for now everyone is inclined to draw a line and concentrate instead on moving towards better, cleaner, fairer and more efficient financial systems. The rewards include cheaper capital to fuel the economy and more saving by trusting consumers. Some reformers, such as Leszek Balcerowicz, the governor of Poland's central bank, think that financial reform can improve even such things as health care and income distribution.

At the heart of these reforms are the ▸▸

▸ banks. They account for about 80% of financial assets in these countries, in most of which securities markets are still widely underdeveloped. Communist bankers did not have to worry about credit risk because neither they nor their borrowers could go bust. After 1990, as market forces kicked in, almost every country in Central Europe had a banking crisis, but each dealt with its insolvent banks in different ways. The Czech Republic, for example, turned a blind eye for years, believing that banks were magical engines of growth. Not until the late 1990s did the Czech government privatise its big banks at huge expense—equivalent to 21% of one year's GDP.

Hungarian reformers were much quicker to cotton on that the banks needed new owners, new capital and new management. They began to privatise them in 1994, judging that the price was less important than getting them into responsible private (which meant mainly foreign) hands. Serbia started reforms only two years ago, emerging from years of war and cronyism under President Slobodan Milosevic. Learning from the experience of others, it closed several of its biggest banks earlier this year, cutting off ailing industries from addictive soft loans. Such prompt action may save Serbia most of the huge expense—equivalent to between 10% and 25% of annual GDP—that delay has cost other Central European countries, but it put 9,000 banking staff out of work overnight. The dusty windows of disused bank branches stare down all over Belgrade.

Foreign umbrella

The other leg of banking-sector reform is foreign ownership. Only a handful of banks in Central Europe have shown that they can compete without the backing of a foreign bank, its risk-management systems, its range of products and its credibility. One of them is OTP, the biggest bank in Hungary. Once a savings bank with a monopoly of the retail market, it has thrived because of good local management. Another, although not so well run, is Bank PKO BP in Poland, which also had a monopoly. Almost all other successful banks in the region are owned by foreign banks. Even Slovenia, which for years resisted big foreign investors for fear of being swamped by foreign capital, sold two biggish banks to foreigners last year, and is negotiating the part-sale of its biggest to a Belgian bank. Neighbouring Croatia has been the most outward-looking: 90% of its banking assets are foreign-owned.

In theory, this foreign ownership plugs the financial sector into the western world, bringing higher standards of governance and better access to capital. More competition means lower lending premiums, especially for small and medium-sized businesses. Foreign ownership also offers a fast track to new financial services such as mortgages and leasing. All of this increases the deployment of funds where they are needed, and coaxes savings from under mattresses and out of offshore accounts. The parent banks usually make a better job than local supervisors of overseeing their new subsidiaries. Often there is an implicit safety net: the parent will not let its offspring go bust, thus providing a lender of last resort for part of the financial system.

But banks cannot do it all. The big disappointment in Central Europe has been the slow development of alternatives: capital markets and private equity. Most of the countries built stock exchanges with great fanfare. Thanks to mass privatisations, some of them had thousands of companies listed. But new capital failed to arrive, or if money came in from abroad, it soon flowed out again as the fad for emerging markets lost favour. Worse, company shares, traded without enough disclosure and without enough volume to establish convincing prices, invited all kinds of market abuse and flouting of minority shareholders' rights. Only now are some of these problems being tackled in the few markets that are not dying a slow death.

On a larger scale, each local capital market is facing a choice: should it fight for its national identity, or append itself to a pan-European exchange? This is not just a question of patriotism. These countries are belatedly trying to build up funded pensions for their citizens. Arguably, a good chunk of those funds should benefit the local economy, rather than be invested in government bonds. Pension and insurance funds are vital to capital markets. They helped Chile build a robust market, and are beginning to do the same in Poland. ▸▸

It took time to recognise that countries emerging from communism desperately need small and medium-sized businesses. Some of them, especially former Yugoslavia (the rump of which, confusingly, is due to change its name to Serbia and Montenegro next year) had an artisan tradition, but in others private initiative was heavily discouraged. In Romania, to kill a pig for Christmas you needed permission from the mayor. The American government started the Polish-American Enterprise Fund in 1990 to foster small business, but the initiative spread only slowly to other countries.

The European Bank for Reconstruction and Development (EBRD) changed tack in 1994 and began lending to banks to encourage small businesses. This approach has been most successful in Russia, and in such unlikely places as Albania, Bosnia & Hercegovina, and Kosovo. The model is Germany's famous *Mittelstand*, the small and medium-sized companies that have proved such a trusty engine of economic growth there. But building up small companies takes time, enlightened loan officers and enforceable procedures for collecting loans and seizing collateral.

The countries of Central Europe do not have time. They are in a race to qualify for the greater Europe. Their legal systems and institutions are being wrenched into compliance with EU law, but their judges, lawyers and administrators find it hard to change their habits of 50 years.

All the same, after ten years of going up blind alleys, most countries in Central Europe appear to be moving forward. They can now choose from a menu of past experiments in banking and financial-sector reform, depending on what stage they have reached. But there are worries that they might go off the rails again. The banks are not lending enough, corruption is not dead, and bloodshed nearby is still a recent memory. Accession to the EU for all or some of the chosen ten still needs to be ratified at the EU's December summit in Copenhagen. Just imagine the financial shock to Poland, says one analyst, if its accession were knocked off course. Plenty went wrong in the past decade. Plenty more could go awry. ■

Grab and smash

In the scramble for state assets, financial discipline was forgotten. Many countries are still paying for the resulting crises

IT SEEMS only yesterday that all of Central Europe was a giant construction site. In the haste to rebuild the economy, banks became the puppets of politicians and the new class of bosses; old factories were carved up by their former managers and machinery disappeared. Multilateral agencies such as the World Bank, the IMF and the EBRD tried their best to help at the birth of these new nations, but their money, too, often went astray.

Most countries made the mistake of attempting to do everything at once. The extreme case was former Czechoslovakia, with its "big bang" privatisation in 1992. Citizens were entitled to buy vouchers which they could exchange for shares in a bewildering choice of companies. Many put their trust in poorly regulated investment funds to make the choice for them. It was a wild era in which a few sharp individuals made fortunes, gathering enough shares to control companies. Many of the assets in which the funds invested also ended up in the control of the fund managers, some of them supposedly respectable western banks. This big-bang world did not bother with too many rules. Poland, Romania, Slovakia, Croatia and, famously, Russia chose voucher privatisations, with more or less similar results. The best that can be said is that these companies were taken off the state's balance sheet, and that investors lost an opportunity but not much money.

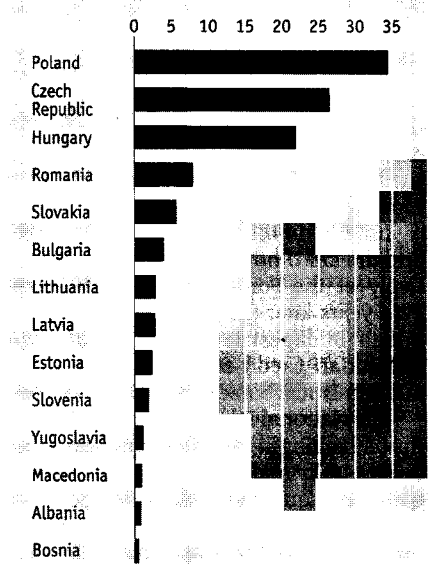
Hungary took a different road, preferring to sell companies to those with real money—that is, foreigners. Hungary's target was to attract $10 billion of foreign direct investment in the first decade. It had already reached that level by 1995, even as other countries dithered over selling the family silver. Only towards the end of the decade did Poland and the Czech Republic catch up and attract more (see chart 1).

Voucher privatisations have since been condemned as a mistake, but the Czech Republic's second wave of privatisation was probably worse. It involved auctions, voucher privatisations or direct sales, often to the companies' own managers. The Czechs' aversion to foreign investment left their entire economy undercapitalised, with dire consequences for companies and their creditor banks.

Much the same happened in neighbouring Slovakia. Ivan Miklos, now deputy prime minister for the economy, recalls his experience on the supervisory board of Slovakia's National Property Fund, from which he resigned after a year: "In that year the fund sold 900 companies, but only one to a foreign buyer. It was impossible [for me] to get information about the sales." National property funds in several other countries were open to this kind of abuse, and even western companies saw opportunities that tempted them to throw corporate governance and rights of minority shareholders to the winds. Some of the canniest wheeler-dealers carried on for years, running companies and banks, bribing politicians and deceiving shareholders; they were suspected of being crooked, yet still feted by a public used to the ways of a communist elite. Some ended up in jail, or vanished.

Rolling in...or not 1

Cumulative foreign direct investment inflows 1989-2001, $bn



Source: European Bank for Reconstruction and Development

Perhaps surprisingly, the Czechs, the most disciplined and orthodox folk under communism, fell further from grace than others. Many now blame the extreme liberal ideas of their architect of reform, Vaclav Klaus, who was prime minister in 1992-98. He believed that freeing the market was more urgent than establishing an institutional framework. For a while western reform gurus, such as Jeffrey Sachs and Larry Summers, lent their support. But today most people believe that Mr Klaus's big bang created little economic growth, but a kleptocracy as bad as Russia's. Until last June the two main Czech parties had a so-called "opposition agreement" under which they refrained from digging into each other's recent history.

Except for some industrial dinosaurs, such as shipyards, metal plants and mines, most industry in Central Europe is now in private hands. That seems a useful outcome, even if ownership was not always properly transferred nor claimants' rights always respected. Noreen Doyle, vice-president of the EBRD, which has stepped around the dirty deals where it could, concludes: "You can't unscramble the past."

The sooner the better

The sick organ that used to keep these kleptocracies alive was the banking system. In Hungary in 1995, the finance minister, Lajos Bokros, and the central bank governor, György Suranyi, saw "deep corruption and cronyism in the banks", recalls Peter Mihalyi, who was then number two at the privatisation agency. Hungary is praised for having tackled its banks early, but it did so for largely pragmatic reasons. From 1992 to 1994 the government several times had to recapitalise the banks that it had spun out of the National Bank of Hungary. In the end it recognised the need for foreign capital. "The only reason we privatised the banks was because they were about to blow up," says Mr Mihalyi.

In July 1994 Bayerische Landesbank and the EBRD bought 25% and 17% respectively of the Foreign Trade Bank (MKB). Two years later the EBRD and GE Capital bought Budapest Bank, ABN Amro bought Hungarian Credit Bank (MHB) and ING, another Dutch bank, bought Dunabank.

The National Bank of Hungary had got the ball rolling in 1989 by selling Tungsram, a light-bulb maker, to RZB, an Austrian bank. RZB quickly made a tidy profit by selling Tungsram to General Electric (GE). The Tungsram deal was "one of the most successful ever made in Hungary", says Mr Suranyi, who is now head of multinational banking at IntesaBCI, an Italian banking group. It was a positive symbol of the whole privatisation process, he says. GE put in fresh capital and quadrupled the firm's light-bulb output in Hungary.

Jacek Siwicki, who was Poland's deputy minister of privatisation at the time, agrees there was a need to attract some big names, such as Pepsi, Goodyear and Henkel, rather than trying to sell shipyards and steel mills. The big names raised Poland's profile and showed investors we were "guys you could do business with", says Mr Siwicki, who now runs Enterprise Investors, the biggest private equity fund in Central Europe. Despite the problems, he marvels at how far his country has come.

But Poland was more cautious than Hungary about selling control of its banks to foreign investors. Although it floated bank shares on the stockmarket and sold minority stakes from 1997, the first majority bank stake it sold was in 1999: 50.1% of Bank Pekao to UniCredito of Italy. The upshot was that in the mid-1990s Polish banks had little access to new capital and western risk-management and IT systems. On the other hand bank shares were traded actively, which benefited the local stockmarket.

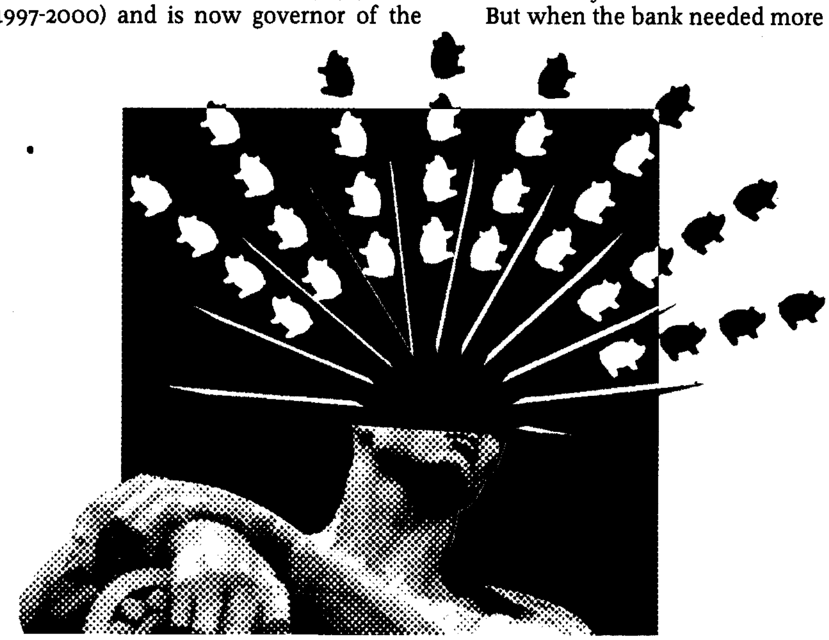
Now around 70% of Poland's banking sector is in foreign hands and the banks are moving towards western standards of service. But this was hardly part of the big bang that Leszek Balcerowicz, Poland's arch-reformer, inflicted on the rest of the economy. Today Mr Balcerowicz, who had two stints as finance minister (1989-91 and 1997-2000) and is now governor of the central bank, talks about the importance of radical and sustained reform and the need to build reliable financial institutions. But Poland, like almost every other country in transition, dragged out its banking crisis: it chose to bail out its banks in 1994 rather than cutting their ties to troubled enterprises.

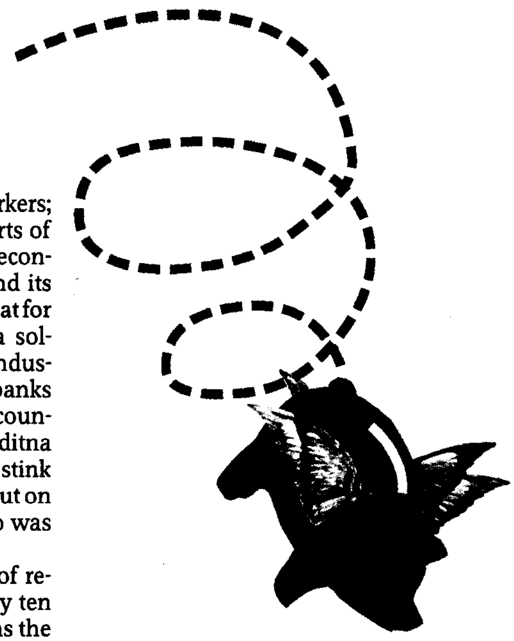
The Czechs paid most heavily of all for botching the clean-up and privatisation of their banks, until the job was eventually done properly. "If you screw up your banking sector, the whole economy suffers," says Joanna James at Advent International, which invests private equity in Central Europe.

Unintended consequences

In 1997 the Czech government made a rather silly mistake that lost it control of a bank without putting it in safe hands. Investicni a Postovni Banka (IPB), the country's third-biggest, needed new capital. The government's National Property Fund, which owned 47% of the bank (and another 3% through an investment fund), inexplicably ducked the capital increase, so its stake was diluted. IPB, although a popular retail bank, had a bad reputation for buying political favours from both main parties. Technically it had now been privatised, but its balance sheet had not been cleaned up. When Nomura Securities, a Japanese investment bank, expressed interest in a minority share, it was hailed as the "western" strategic shareholder that would give IPB world status and credibility.

But when the bank needed more capi- ▸▸





tal, Nomura saw no reason to oblige. It had already made a tidy profit by selling two breweries owned by the bank and its investment funds to a South African buyer. It wanted the government to step in and make the bank saleable to a foreign buyer. In June 2000 there was a run on IPB, on rumours that it was about to report more losses. The government intervened on a Friday, sending in special forces sporting balaclavas and sten guns. Without time to organise a proper auction, and fearing a systemic banking crisis, the government decided to hand over IPB on the following Monday to Ceskoslovenska Obchodni Banka (CSOB), the best-run local bank, which had been sold to KBC of Belgium the previous year. It was a controversial and costly move that allowed CSOB to acquire another bank virtually risk-free. It could cherry-pick assets from the IPB portfolio and consign the rest to the bank consolidation agency, in exchange for government bonds.

This was the second time the government had ended up paying top dollar to get a bank off its hands. The first had been early in 2000 when it agreed to the sale of the biggest savings bank, Ceska Sporitelna, to Erste Bank of Austria. Sporitelna's existing loan book was ring-fenced: Erste and the government could pick the loans they wanted, and the rest went to the consolidation agency. But the government eventually learned its lesson. When it sold the last big bank, Komercni Banka, to Société Générale last year, it insisted that the French bank buy the loan portfolio and the bank as a package deal.

Slovakia, which split away from the Czech Republic in 1993, did little to privatise its banks until 1998, when the xenophobic leadership of Vladimir Meciar came to an end. Six banks had collapsed in five years. The gross cost of restructuring the three biggest banks was the equivalent of 11% of GDP, according to Ivan Miklos, deputy prime minister for the economy. The net cost, after selling the banks and auctioning their bad loans, will be between 4% and 6% of GDP, he estimates. The buyers of the three banks were Erste of Austria (adding Slovenska Sporitelna to its sister savings bank in the Czech Republic), IntesaBCI of Italy and OTP of Hungary.

The war in the Balkans meant that only Slovenia, the smallest and least affected of the former Yugoslav republics, was able to establish strong links with western economies. It had a head start. Even under Yugoslav socialism, the Slovenes had close ties with western businesses. Many had worked in Germany as guest workers; many of the brightest from other parts of Yugoslavia had settled in Slovenia as economic refugees. But Slovenia's size and its hostility to foreign influence meant that for years it resisted foreign capital as a solution for its banks and cash-starved industries. When Austrian and Italian banks two years ago were eyeing up the country's second-biggest bank, Nova Kreditna Banka Maribor, "there was such a stink from its citizens that the project was put on hold," says an American banker who was there at the time.

Slovenia's concern, beside a fear of recolonisation by neighbours after only ten years as an independent country, was the stability of its currency in the face of large capital inflows or outflows. Grudgingly, under pressure from the European Union, the government allowed foreigners to buy minority stakes in banks. Société Générale bought a minority stake in SKB Bank and was later able to build a majority, which included taking over a 14.9% stake held by the EBRD. SanPaolo IMI, an Italian bank, bought a 62% stake (but with only 33% of the voting rights) in Banka Koper last year. The jewel is Nova Ljubljanska Banka (NLB), the country's biggest. "I would have bet my salary a year ago that this bank would never be privatised," says Murat Yildiran, the EBRD's representative in Ljubljana. But in May, KBC of Belgium won agreement to take a 34% stake, with the option of buying more over five years, though the sale still needs approval from the National Bank of Slovenia.

Serbia, less than two years into its reforms, has shut 23 banks, including four of its five biggest in January this year. Did it jump or was it pushed? The World Bank and others had plenty of advice for it. A World Bank survey on financial transition, published in July 2001, pointed clearly to the high cost of delaying bank reform. But taking the plunge still needed courage. Mladjan Dinkic, the governor of the National Bank of Yugoslavia, used a form of controlled bankruptcy to close the banks, giving plenty of warning to foreign interbank depositors to withdraw their money.

Unloved assets

Serbian investors were not sorry to see these banks go because Slobodan Milosevic, the then president, had seized their foreign-currency deposits to finance his wars in Bosnia and Kosovo, replacing them with near-worthless government bonds. The cost of the bank closures in January was about $4 billion, the equivalent of 1% of GDP, modest compared with similar moves in other Central European countries. Now the banks are being prepared for sale towards the end of the year.

"We paid a high political price for closing the banks," says Miroljub Labus, deputy prime minister in the Serbian government. "Now the banking sector is improving and savings are growing." He fails to mention the bank they did not close, Komercialna Banka, which is popularly known as the "police" bank because of its closeness to the security forces: rumour has it that this bank was too sensitive even for Mr Dinkic to touch. But now it is a possible choice as a home-grown banking champion. "I would like to see two or three domestic banks competing with foreign banks, something like OTP in Hungary," says Mr Dinkic. OTP, Hungary's biggest bank, floated its shares on the stock exchange rather than acquire a foreign strategic investor.

Croatia, a war zone until the Dayton accords in 1995, spent the equivalent of around 22% of GDP rehabilitating its four biggest banks the following year. But there was a second banking crisis in 1998-99 when two big banks and several others became insolvent, costing another 5% of GDP to sort out. In April 2000 there was a run on Bank Istarska, which the government halted. It was time to look abroad for buyers. Within a year three big banks had been sold to foreigners—IntesaBCI and UniCredito of Italy, and Germany's Bayerische Landesbank. A British investment fund, Charlemagne Capital, also bought three banks. That put around 90% of Croatia's banking assets into foreign hands. More nimbly than other countries, Croatia was outsourcing the recapitalisation and to some extent the supervision of its banking sector. Thereby hangs a tale. ■

Rogue trader, rogue parent

Most of the banks in Central Europe have foreign owners. That is no guarantee that they will be well run

CENTRAL EUROPE has its own Nick Leeson or John Rusnak in the person of Eduard Nodilo, a dealer at Rijecka Banka, Croatia's third-biggest bank. Mr Leeson was the rogue trader who brought down Baring Brothers, a British merchant bank, in 1995; Mr Rusnak inflicted a $690m loss on Allied Irish Banks earlier this year. Mr Nodilo, for his part, accumulated $98m of foreign-exchange losses before they were discovered in February, wiping out the bank's capital. Like his western counterparts, Mr Nodilo had been hiding losses for several years. The market had noted that he was trading unusually high volumes, but the board of Rijecka Banka, when quizzed by regulators at the Croatian National Bank, said that everything was in order. Nor did Rijecka's parent, Bayerische Landesbank, ring the alarm bell—until it was too late.

So who was responsible? Bayerische Landesbank had bought the bank from the government two years earlier, which should have given it plenty of time to do due diligence. The bank had been valued by experts. The Croatian supervisors had overall responsibility to ensure the bank was properly run. But where there is a foreign parent, hard-pressed bank supervisors in Central Europe tend to rely on its usually more rigorous controls. In Europe, at least, the parent's supervisor tends to look at the whole group, including foreign subsidiaries.

Even so, the fraud at Rijecka remained undiscovered for a surprisingly long time. When it came to light, Bayerische Landesbank did a rapid internal audit and decided to sell the bank back to the Croatian government for one kuna (about 14 US cents). By disposing of its purchase for next to nothing, the German bank had lost its capital stake of around $70m. Even so, Cedo Maletic, a vice-governor of the Croatian National Bank, thinks it did not do enough: "Banks aren't shoes to be put in the garbage." Bayerische Landesbank does not owe Croatia anything, he says, "but if it wants to buy another bank here—no chance." Oddly, outside Croatia nobody took much notice of the bank's troubles.

Bayerische Landesbank owns another Central European bank, the Hungarian Foreign Trade Bank (MKB), in which it had bought a stake in 1994 and taken a majority in 1997. Through its affiliate, Bank für Arbeit und Wirtschaft (Bawag), it also has a stake in Istrobanka in Slovakia. Would it drop those too if they got into trouble? It argues that Rijecka was a special case—the fraud meant a time-bomb was lurking even before the government sold the bank.

Back-hander index 2

Firms were asked to comment on the following statement: *"It is common for firms in my line of business to pay some irregular unofficial payments to get things done"*.
% of firms bribing "frequently, "mostly" or "always"*

*Response categories were: never, seldom, sometimes, frequently, mostly or always
Source: European Bank for Reconstruction and Development/World Bank survey, 1999

A better class of investor

Foreign banks that have taken majority or even minority stakes in Central European banks are known as "strategic" investors, which means something more than a portfolio investor who buys and sells bank shares. Local regulators assume that strategic investors have a commitment to their affiliate, and that they aim to apply the same standards of ethics, governance and risk management to it as they do at home. There have been a few disappointments, but most Central European regulators think that in general this has worked. György Suranyi, a former governor of the National Bank of Hungary, says a risk remains, and there is a need for tight supervision, but "the bulk of the responsibility lies with the strategic investor." He represents such an investor himself now, as head of multinational banking for IntesaBCI of Italy, which owns banks in Hungary, Croatia and Slovakia. The Italian and Austrian parent banks in particular, having built a network of banks in the region, insist that they stand behind their subsidiaries.

The Rijecka case was a disappointment because Bayerische Landesbank was not prepared to back its subsidiary when it got into trouble. The German bank had problems at home, as the biggest creditor to the troubled Kirch media group. It was also alarmed by initial reports that the losses at Rijecka could be far bigger than they appeared, and that the entire bank was crooked. However, in May it managed to sell Rijecka Bank to Erste Bank of Austria for about $55m.

Other retreats by strategic investors have been more understandable. Nomura Securities, which bought 40% of Investicni a Postovni Banka in the Czech Republic, was hailed at the time as a strategic investor. The Czech authorities even had a letter of intent from Nomura, undertaking to bring some expertise to the bank. But when IPB got into trouble, Nomura did not regard itself as responsible. After all, it is an investment bank. It was a lesson to the Czechs that they should find more appropriate strategic investors in future. They have done so with subsequent bank sales.

A handful of other foreign parent banks have been unlucky. Bankgesellschaft Berlin, in trouble because of its east German property portfolio, sold its Czech subsidiary, Zivnostenska Banka, to UniCredito of Italy in August. Kent Bank of Istanbul went bust in the Turkish banking crisis in 2001 and its Albanian subsidiary, National Commercial Bank, became the property of the Turkish government. That did not please Albanians, who had suffered Ottoman rule for centuries until 1913. Similarly, Demirbank in Romania was orphaned after its eponymous Turkish parent failed. It was bought by UniCredito. If subsidiary banks like these are well capitalised and properly supervised, there should be no problem finding another buyer if the parent gets into trouble. But the message to local supervisors is clear: they should not relinquish responsibility for the banks on their turf.

Polish supervisors are probably taking ▸▸

their strategic investors too much on trust. Several foreign-owned banks in Poland have a high level of non-performing loans—up to 60% in one instance—but a much lower level of loan-loss provisions. The shortfall tends to be guaranteed by the parent. "A lot of foreign banks don't meet the standards," says a local banker.

Second division

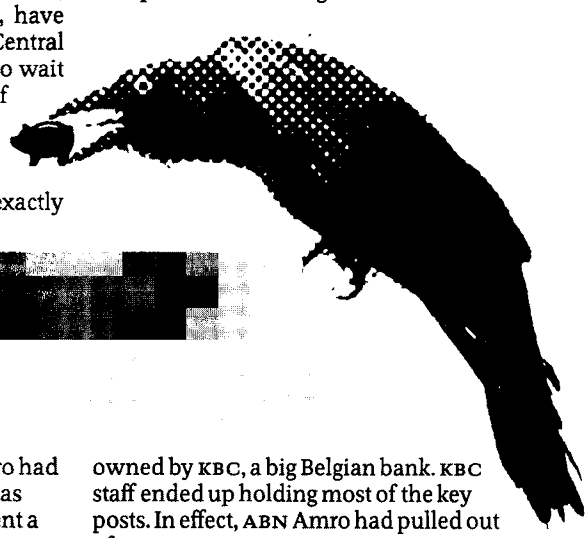
Several West European banks have shown real commitment to the region. Two Austrian banks, Erste Bank and Raiffeisen Bank, have become more Central European than Austrian. Erste owns the biggest savings banks in the Czech and Slovak Republics, employing nearly three times as many staff there as the parent does in Austria. It also has banks in Croatia and Hungary. Raiffeisen Bank owns Tatra Bank, reckoned to be the best private bank in Slovakia, and has subsidiaries in 12 other countries in the region. Other committed parents are KBC of Belgium, with CSOB in the Czech Republic and Slovakia, K&H in Hungary, Kredyt Bank in Poland and, subject to negotiation, 34% of Nova Ljubljanska Banka in Slovenia; UniCredito, with a big bank in Poland, Pekao SA, and others in Bulgaria, Croatia, the Czech Republic, Slovakia and Romania; IntesaBCI, with banks in five countries in the region; and Société Générale with Komercni banka in the Czech Republic, and others in Bulgaria, Romania and Slovenia. Allied Irish Banks owns two banks in Poland, which it has merged. It landed in that country almost by accident, having offered technical assistance to one of the banks under a World Bank programme.

However, none of these parent banks is in the first league. Central Europe tends to be the stamping-ground of second-tier banks. Where are the Citibanks, J.P. Morgans and Deutsches? And where are the British, especially HSBC, that emerging-market specialist? True, Citibank bought the biggest Polish corporate bank, Bank Handlowy, in 2000, and has been present in Hungary for 16 years. But even Citibank, and certainly other top-tier banks, have not been punching their weight in Central Europe. Perhaps they are planning to wait for a few years and then buy one of the Austrians or Italians along with their Central European network.

HypoVereinsbank of Germany, though not in the big league, did exactly that when it bought Bank Austria, which has a retail and investment-banking network in most Central European countries, having itself merged in 1997 with Creditanstalt of Austria, one of the pioneers of banking in Central Europe. ABN Amro, a Dutch bank, merged its Hungarian bank with one owned by KBC in a joint venture which is now under KBC management.

There will undoubtedly be further consolidation of banks in the region, either because their parents merge or because they sell out. According to Wojciech Kostrzewa, chief executive of BRE Bank in Poland, "You need a market share of 10-20% in markets which aren't artificially regulated. Most banks here are too small."

Mr Kostrzewa expects more departures like that of ABN Amro from Hungary (see box below). BRE Bank, the region's only self-proclaimed indigenous investment



In and out

ABN Amro's Central European excursions

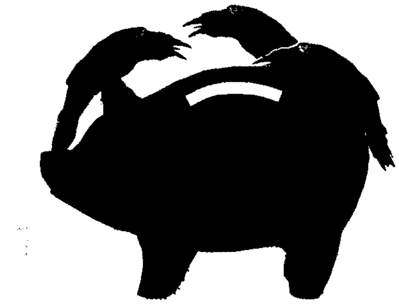
ABN AMRO, a big Dutch bank, has a tradition of venturing into wild places in pursuit of customers. In the early days of post-communist transition it was everywhere. In 1996 it bought Hungarian Credit Bank (MHB), and invested a huge amount refurbishing its branches. Even in the smallest provincial branch, everything had to be done ABN Amro's way, down to the office furniture imported from the Netherlands and expensive IBM hardware.

The management style too was imposed from Amsterdam, although the bank hired good local people. Accustomed to operating in former Dutch or British colonies, ABN Amro prefers to send out "soldiers" from head office. Whether those soldiers are good or bad, they usually stay for no more than three to five years, and are often preoccupied with office politics and promotion prospects back home.

Despite this weakness, ABN Amro had an expanding business in Hungary, as well as in Poland, where in 1996 it sent a good Dutch soldier as country manager. He persuaded his bosses in Amsterdam that ABN Amro should buy a Polish bank. It had already looked at BPH, a medium-sized corporate bank in 1994, but balked at the price, and BPH was floated on the stock exchange the next year. By early 1998 ABN Amro was all fired up to buy it. But a change of management in Amsterdam and losses from financial crises in Russia and Brazil made it hesitate, and the Polish bank was snapped up by HypoVereinsbank of Germany. The blow to morale at ABN Amro in Warsaw has since caused key staff to leave.

Meanwhile, in Hungary, ABN Amro Magyar Bank lost money every year from 1995 to 2000, according to former staff. In July 2001 ABN Amro struck a deal to merge ABN Amro Magyar Bank with K&H, owned by KBC, a big Belgian bank. KBC staff ended up holding most of the key posts. In effect, ABN Amro had pulled out of Hungary.

Observers think ABN Amro may have been a victim of its own successful recruitment. Among its alumni is Zsigmond Jarai, a former finance minister and now the president of the National Bank of Hungary. The current finance minister, Csaba Laszlo, managed the merger between ABN Amro's bank and K&H. Another former ABN Amro manager is now chef de cabinet to the prime minister, Peter Medgyessy. Two of the bank's senior expatriate managers moved to Citibank and Raiffeisen Bank respectively. Another Hungarian alumnus runs Raiffeisen Bank in Belgrade. ABN Amro seems to have played an important part in the development of Central European banking without getting much of either the benefit or the credit.



bank, expects to be involved as a dealmaker. BRE Bank is 50% owned by Commerzbank, one of Germany's universal banks. It is involved in some Polish industrial workouts, such as bankrupt Elektrim, which is feared to be eating into its risk ratios. Would Commerzbank stand behind BRE? Eyebrows have been raised in the banking community at BRE's readiness to take equity stakes in companies, while funding itself with short-term retail deposits. "He's running his bank like a hedge fund," says a local investment manager of Mr Kostrzewa. But auditors and supervisors seem happy, one even calling BRE "the best-run bank in the country". The risk ratios look all right, say correspondent banks grudgingly. Mr Kostrzewa complains that he is singled out because no other bank is taking equity risk. He sings the praises of the British merchant banks of yesteryear, and of Mediobanca, which restructured corporate Italy in the 1950s and 1960s.

Croatian supervisors are less than delighted by the presence of Charlemagne Capital, a British-based manager of equity funds, which has been able to build up and control a considerable banking group in Croatia. Charlemagne, until last year known as Regent Europe, bought its first two Croatian banks, Dalmatinska Banka and Istarska Banka, in 2000 from the government's bank rehabilitation fund. The national bank supervisors had no control over the sale. Charlemagne has since added another regional bank and will merge them all, moving the headquarters to Zagreb and calling it Nova Banka.

Charlemagne has no obvious banking expertise, apart from a similar control of Hebros Bank in Bulgaria. Alarmingly, after buying the Croatian banks it stopped their operations for a while, which cannot have been good for business. Charlemagne's declared strategy is to improve the banks and resell them in three to seven years. Meanwhile it is bidding for another Bulgarian bank, Biochim.

Taking the rough with the smooth

Foreign non-banks may not be the ideal parents for Central European banks in transition, but then countries cannot always be too choosy. The first bank that Hungary sold control of was Budapest Bank, in 1996, to GE Capital. "The deal was badly structured and included political involvement," recalls someone close to the sale. The new owners severely reduced the bank's product range and turned it into little more than a consumer finance house. GE Capital is reckoned to have made plenty of money, but it did not shower the market with new products and credit cards, as the sellers had hoped.

The EBRD has invested in the equity of more than 80 banks in transition countries, usually accompanying a foreign strategic investor. It sees this as a vital part of its job, although it has had to be pragmatic about some of its business partners. "If we don't like what we see, we just withdraw from the board," says Kurt Geiger, director of the financial-institutions group at the EBRD. In many cases it has sold its stake once the bank is on a steady path.

For the time being these banks, answerable to foreign parents, are the dominant source of finance in these economies. That is not strictly healthy. Debt financing can be fickle in times of trouble. Foreign owners may suddenly lose interest in the local economy and decide to put their resources elsewhere.

For now, these countries are relying too heavily on these foreign-owned banks to provide their working capital. In principle, local sources of capital—securities markets, pension funds, insurance companies—are available. But as yet they do not offer a real alternative to the banks. ■

Capital punishment

Troubled local stockmarkets are looking west for allies. Many of them will not survive

WOOD & COMPANY claims to be Prague's biggest equity broker. It used to be even bigger, boasting offices in Poland, Hungary, Slovakia and Ukraine as well as in London and Istanbul, but that was before equities had felt the full effect of the Russia crisis of August 1998, which sent a shock through capital markets around the world. Now Wood has shrunk to two locations, Prague and Bratislava, although it still does some cross-border business. Richard Wood, the founder, has long since moved on.

Most stockmarkets around Central Europe are dying. In Prague, there has not been an initial public offering (IPO) of shares since the 1930s, even though thousands of companies were listed in the 1990s during the mass privatisations. The Czech stockmarket is not a place to raise new capital. Over 100 companies are still listed, but only a handful are actively traded, none of them blue-chip names.

Hungary's stockmarket is marginally better. It does have some blue chips, such as Mol, an oil company, Matav, a telecom company, and OTP, the country's biggest bank. It has even had some proper IPOs, though the last one, of Synergon Information Systems, was in 1999. Volumes are still desperately low. "I'm afraid Hungary will go the way of the Czech Republic," says Petr Koblic, chief executive in Prague of CAIB, the investment bank of the German HVB group.

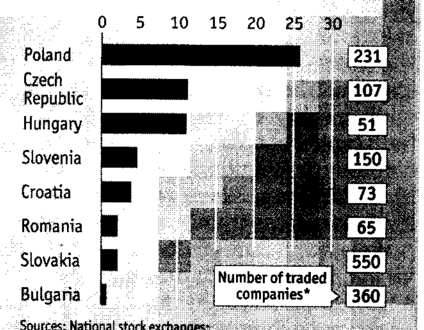
In Belgrade the technocrats—some of them former bond traders at Wall Street firms—have decided, sensibly, that equity markets must wait until Serbian companies have become more transparent. Meanwhile, they are building a government bond market. A corporate bond market may follow.

Arguably, the only equity market in the region that is big enough to be sustainable is Poland. The Warsaw Stock Exchange has a market capitalisation of around $26 billion, more than all the neighbouring stockmarkets combined. With a population of nearly 40m, Poland would expect to have bigger companies, bigger investment institutions and a bigger number of retail investors than its neighbours. Romania, the next most populous country in the region, with around 22m, should be able to sustain a national stockmarket too, but it is a long way behind Poland, Hungary and the Czech Republic.

And even in Poland, there are doubts whether a national stock exchange can

Uncritical mass 3

Stockmarket capitalisation*, $bn



Sources: National stock exchanges; Federation of European Stock Exchanges *Latest available data

survive European consolidation. Turnover has dwindled to $25m a day. Belgium, France and the Netherlands have already merged their stockmarkets to create Euronext. The Warsaw Stock Exchange has signed a cross-marketing agreement with Euronext, but has made no commitment to join up. Being 98% owned by the Polish treasury, it cannot take such a decision on its own. But by the end of this year Wieslaw Rozlucki, chief executive of the exchange, should be able to agree with the treasury on whether to look for a strategic partner, or whether to slug it out alone. There have been proposals for a regional exchange based in one of the bigger countries, but Mr Rozlucki thinks that is a bad idea. The market would lack critical mass, he claims, pointing to Vienna's attempt to become a hub for Central European stocks. A Viennese exchange, Newex, aimed at regional companies, was actually traded electronically in Frankfurt—and proved a failure: it has just been absorbed by the Frankfurt exchange.

Great expectations

Perhaps too much was expected of Central Europe's fledgling stock exchanges. An American agency, US Aid, spent millions of dollars on projects to establish capital markets in a post-communist wasteland. But setting up a stock exchange is one thing; creating the necessary conditions for an active equity market quite another.

A healthy stockmarket needs transparent reporting by companies, good corporate governance and a respect for shareholders' rights. Those conditions often lag a long way behind the launch of share trading. Second, it has to have a domestic investor base. Too often, nascent stockmarkets have attracted a flood of speculative investment from abroad, only to see it disappear at the first hint of trouble. The obvious answer is to build a class of institutional investors, starting with pension funds, and to encourage mutual funds and private portfolio investors. Third, listing on an exchange must be attractive to companies. Many smaller businesses are deterred by the cost and the disclosure requirements. Fourth, the underlying economy should have a track record of reasonable stability. In many countries a flurry of equity mania in the early 1990s was followed by high inflation and a stockmarket bubble which severely damaged the value of investments.

Poland is ahead in the game because it avoided a market bubble, and took trouble to build up pension funds. Since 1999 all employees born before 1969 have been obliged to contribute 9% of their salary, of which a portion goes into private pension funds. That has produced funds totalling around $6 billion so far. Some 40% of that money can be put into equities, of which 5% may be invested abroad. That gives the Polish market a predictable expansion of its equity base, encouraging other investors to come in too.

Hungary reformed its pension system in 1998, but its pension funds are growing only slowly in a thin equity market. Many companies were sold to foreign investors rather than being listed on the Budapest Stock Exchange. However, there were some landmark IPOs, starting with Danubius in 1992. The government also chose to list Mol and OTP rather than sell stakes to strategic investors.

The Czech Republic, having seen many privatised companies delist for lack of investor interest, might be able to revive enthusiasm by floating a small equity slice of companies it has privatised recently. Erste Bank of Austria, having completed its takeover of Ceska Sporitelna, the big local savings bank, had to delist the stock, but intends to fill some of the gap by issuing its own shares on the Prague market in October. Traders are sceptical that this will add much liquidity locally. Share trading will gravitate to the market where a company's shares are most heavily traded. Although the region's blue chips, such as Mol and Poland's KGHM, are listed in London or Luxembourg, the share price is still determined locally and most of the trading is done on the spot.

However, because of the consolidation of exchanges in Europe, and the growing share of institutional trading, Central European exchanges will be increasingly isolated unless they have links into the West. Mr Rozlucki at the Warsaw Stock Exchange accepts that Poland's blue chips may migrate to a multinational exchange, and that Warsaw should be part of a wider structure. But for small and medium-sized companies, he believes disclosure of corporate information, price discovery and the surveillance of companies and brokers will stay closer to home. The Warsaw exchange is in with a fighting chance "if we can provide alternative sources of capital", says Mr Rozlucki.

Local attractions

Jan Sykora, a partner at Wood & Company, believes there will be a role for local regulators as "gatekeepers to the global market". But he is sceptical whether, eventually, local listings will work "when there's so much consolidation of asset managers and investors". Warsaw may retain more local interest, but on the Prague exchange 99.5% of the trading volume is institutional orders and 95% of those are from abroad, says Mr Koblic at CAIB. Slightly more promising is the Czech Republic's corporate bond market, which is bigger than Hungary's, Poland's and even Spain's (see table 4). But it reflects the fact that Czech companies have great difficulty raising bank loans: in 1999-2000 they repaid more to local banks than they borrowed.

One thing that would help the region's stock exchanges is progress on corporate governance. Shareholders' rights continue to be abused. An inadequate legal system means that redress takes years, so most people do not pursue cases. A company's management "can still present an illegal action to shareholders and get away with it", says an investment banker in Prague.

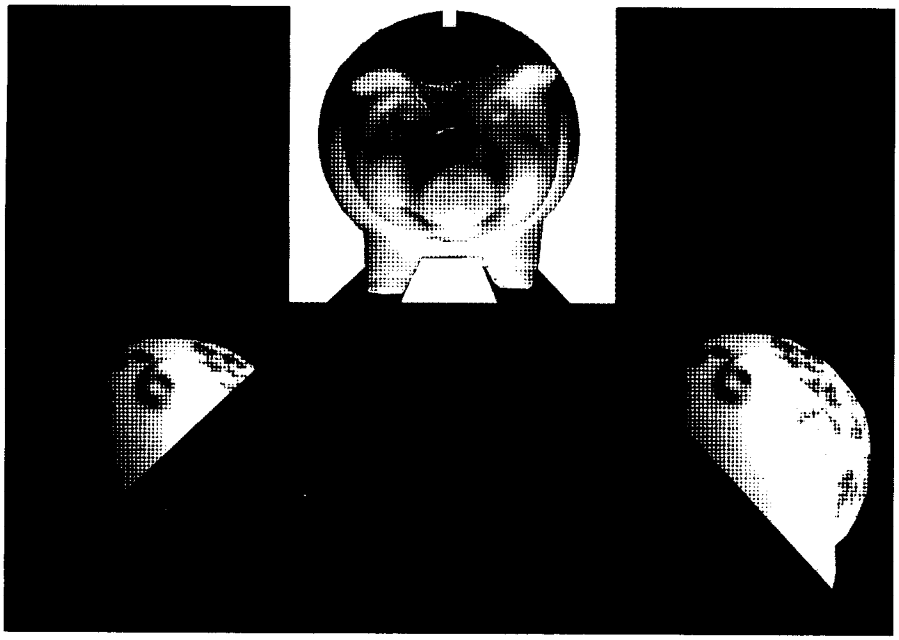
The worst abuses of the early days involved companies and the government-inspired national investment funds stripping out assets under shareholders' noses—"tunnelling", as it was called. Another common peccadillo was for strategic investors to pay a premium for a control- ▸▸

Backward bond markets 4

Outstanding domestic debt securities as % of GDP end 2000

	Financial	Corporate	Total*
Germany	49.7	1.3	90.2
Portugal	16.1	9.6	61.7
Spain	5.3	4.8	59.0
Czech Rep.	5.5	5.3	46.1
Hungary	na	1.5	35.5
Poland	na	0.0	20.3

Source: European Investment Bank *Includes public bonds



ling stake in a company without making a general offer to shareholders. Mol, the Hungarian oil company, did this when taking over Slovnaft, its counterpart in Slovakia. "At that time no full bid was required," parries Zoltan Aldott, head of strategy at Mol, and also a board member of the Budapest Stock Exchange. "If we increase our stake now, we will make a public offer."

Would you do this at home?

HypoVereinsbank, a German bank, paid the Polish treasury more than twice as much per share for Bank Przemyslowo-Handlowy (BPH) than it paid minority shareholders. ING, a Dutch bank, took a majority stake in Bank Slaski, another Polish bank, then made huge provisions on the balance sheet, depressing the share price before buying out the minority shareholders. These foreign companies were taking advantage of lax local regulation to do things they could not get away with in their home countries.

Poland now has two committees working on corporate governance. In Romania the chief executive of the Bucharest stock exchange, Sergiu Oprescu, has started a new category of listing for super-compliant companies, called the "transparency-plus tier". Two have applied, but so far neither has achieved the upgrade.

Raimondo Eggink, a Dutchman, led the first legal challenge by minority shareholders in Poland, against Michelin of France for unfairly transferring profits from its listed local subsidiary, Stomil Olsztyn. In 1999, he also sued a Polish company for paying a premium to shareholders with a stake of more than 1% when it delisted its stock. In fact, the company was acting within the law, but Mr Eggink claims that the law in question is unconstitutional. The case has been in the High Court for a year and a half. "If it's thrown out, I'll take it to the Constitutional Court," he says stoically. "I'm doing it for fun." He is paying his own legal costs, which so far have been modest. It seems that Mr Eggink's activism has won sympathy in high places: the treasury recently made him a member of the supervisory board of the stock exchange.

Perhaps it was too much to expect Central European countries to develop mature and properly regulated securities markets within a few years when it took centuries to develop them in the West; and given the poor examples of corporate governance offered by Enron and a growing list of other western companies, it seems that even mature markets are no guarantee against abuse. But there is an alternative way to encourage an equity culture in the region: direct private investment in unlisted companies.

Horizonte Venture Management, a small private equity firm in Slovenia, has had two investment failures. In the first, it backed a company that had no international market for its product. The second was due to a scam: a Slovenian firm it invested in bought overpriced, inappropriate machinery from an Austrian entrepreneur, which he had found second-hand in the Czech Republic. But apart from those, Horizonte has done well, venturing first into Slovenia, then Bosnia & Hercegovina and finally Croatia. In 1992, when Slovenia was only a year old and its continued independence looked shaky, Horizonte was having trouble raising money for a Slovenian fund. A Dutchman at IBM's pension fund came to the rescue. He had been to Slovenia and judged that it was already the best-run economy in Central and Eastern Europe.

Private equity can enter these new market economies early because it requires little infrastructure—just an agreement between investor and entrepreneur. If the investor has found the right person the business grows, and within three to seven years it is sold to an acquisitive company, or listed on the local stock exchange.

A lot can go wrong, and hand-holding is essential. The entrepreneur may need help with developing foreign markets, raising fresh capital or taking out patents to protect his product. A hands-on private equity firm like Horizonte gets involved at this working level, as well as trying to ensure the company is run according to standards the investors demand. Apart from good corporate governance, the usual stipulation is no drugs, no arms and no prostitution. As it happens, a drug company of the legal kind is one of Horizonte's most promising Slovenian investments: Transcell, a pharmaceutical firm with ambitions to become a world leader in the treatment of tumours.

Serial entrepreneurs

The challenge for private-equity investment firms is to find a certain kind of entrepreneur who is skilled at building up a business, but not set on preserving it as a family heirloom. "Private equity breeds a class of serial entrepreneur," says Pierre Mellinger, who runs AIG-CET Capital Management (Poland) in Warsaw. As yet, those entrepreneurs cannot be too picky about their source of funding in the region. In essence, their choices are to find the finance themselves, take a bank loan or team up with a private equity investor. The leadership provided by this new class of entrepreneur is very important for an economy, says Kurt Geiger at the EBRD.

Poland is the most popular place for private equity investment because it has the biggest population, but that may be short-sighted. Miroljub Labus, the deputy prime minister of Serbia, is striving for a customs union of those Central European countries at the back of the queue for EU accession. This should create a bigger internal market and attract more foreign direct investment, he argues. But finding good managers is a challenge, and anyone over 45 is usually too set in the nannyish ways of central planning to run a competitive business. "We need a new breed of people who will take the risk of making decisions," says Dan Pascariu, who used to run the Romanian Foreign Trade Bank and now heads a German bank subsidiary, HVB, in Bucharest. "We all carry too much baggage; the 26-year-olds don't."

The EBRD has invested in more than 80 private equity funds over ten years and has made about 800 separate investments. To have the bank on board is good for marketing one's fund, says Piotr Bardadin, who runs Renaissance Partners in Warsaw, and investors like its insistence on high environmental standards. The EBRD has found that the bigger funds tend to do best, perhaps because they have more resources for doing due diligence and carry more clout with host governments and with the companies they invest in. The EBRD's internal rate of return on its investment in these funds is in the high teens, says Mr Geiger. It has its own equity portfolio too, much of it invested in banks. Apart from a few bank failures in Russia, Estonia and Latvia, the banking portfolio has done well, providing the EBRD with an internal rate of return of around 20% a year since its first investment in 1992.

Enterprise Investors (EI), based in Warsaw, is the biggest and earliest private equity manager in the region, with around $4 billion-5 billion under management. Its boss, Jacek Siwicki, was at the privatisation ministry in the heady days of mass privatisation. EI's charter allows it to invest 30% of its funds outside Poland. It has made investments in Romania and Slovakia. Mr Siwicki thinks that private equity in Central Europe is not that far behind practice in the EU or even North America, where private equity funds started in the 1970s. The challenge is to find an exit, given that even the Warsaw Stock Exchange is not a great place for IPOs (although EI recently floated a jewellery business for about $4m). The company has recently done well with sales to strategic investors: it sold a small-business bank to Fortis and a mortgage bank to GE Capital.

Private equity is not always the best tool. There is room for other kinds of venture capital in the region, for entrepreneurs or business owners who do not want to give up equity. The EBRD has teamed up with Mezzanine Management to launch a fund for mezzanine finance—development capital in the form of high-yield debt, often with some equity characteristics. Accession Mezzanine Capital, with €75m in its kitty, is aimed not at entrepreneurs directly, but at private equity funds dealing with entrepreneurs who want to keep their business.

During a decade of assisting transition in Central Europe, development agencies such as the EBRD, the World Bank, the European Investment Bank and Kreditanstalt für Wiederaufbau have increasingly concentrated on helping small businesses get bigger. Now even those banks that started off by financing corporate giants and masterminding mergers and acquisitions have turned their sights to small and medium-sized enterprises. That can only be good for those who want to start their own business. ■

Back to nursery school

Small-business finance is at last beginning to get the attention it deserves

THIS is how a small business died. Fifteen years ago, Aniko, a blonde, feisty mother of two, worked for one of Hungary's centralised foreign trade organisations (FTOs), selling honey to Western Europe. She was one of the privileged few who travelled to trade fairs and socialised with foreign buyers. When the FTO closed in 1991, she was left jobless and began to sell honey herself, using her contacts with beekeepers and foreign clients. But she needed finance to bridge the gap between buying the honey and getting paid herself. One Hungarian bank obliged, charging interest at 37.5% and taking the family house as collateral. Business improved, interest rates came down and Aniko had a nice little earner—until 1999, when the EU began to dismantle its tariffs on agricultural imports from Central Europe. The duty on Hungarian honey was cut from 16% to 10%. But, rather unfairly, the duty on Czech, Slovak and Romanian honey went down from 16% to zero.

Hungary's beekeepers protested. If only they had kept their mouths shut. Their protests alerted the banks, which decided they could no longer lend to the honey trade while Hungary had "this international honey problem". Aniko's bank, K&H, a Hungarian subsidiary of KBC of Belgium, refused to provide finance, even when she produced a firm order from a loyal German buyer. Unfortunately she had already spent the 16m forints ($63,000) she would have made on the German deal, so she had to let down the beekeepers, close the business and remortgage her house. Now she is selling honey again, but on 2% commission.

Of course every bank must stick to its credit policy. There may have been good reasons why K&H could not lend. But undoubtedly many small businesses are being starved of finance in Hungary, Poland, Slovakia and elsewhere, simply because they do not meet inflexible credit criteria.

In Serbia, the surviving banks—after the closure of 23 in the past year—are awash with deposits, but they are not inclined to lend to small businesses, says Mladjan Dinkic, governor of the central bank. "One reason is the potential risk, but they also don't have the skills to evaluate credit." The same is true of most banks in the region, although their foreign strategic partners are beginning to change that. The danger is that credit-point-scoring systems of the sort used by banks in the West are too crude to fit individual circumstances.

Nursing small and medium-sized enterprises (SMEs) in Central Europe to create a much-needed *Mittelstand* is still too labour-intensive to be profitable: it needs technical assistance and some subsidy. Some help has been forthcoming from America, not least because of a perceived need to keep Central Europe onside: after all, much of it is run by retooled former communists. In 1989 America's Congress voted to set up the Polish-American Enterprise Fund, which pioneered the development of smaller businesses in the region. By 1994 it had invested around $200m. It was followed by the Russia Small Business Fund, and similar funds for Bulgaria, Ro-

Starter packs 5

Micro-and small lending, April 2002

	Project	Amount of loans outstanding $m	Arrears >30 days, % of loans outstanding
Albania	FEFAD Bank	15.4	3.44
Bosnia	MEB	19.2	0.92
Bulgaria	Procredit	10.9	0.00
Kosovo	MEB Kosovo	11.6	0.16
Romania	Romania MFI	5.8	0.75
Russia	RSBF	156.5	0.81
Yugoslavia	MFB	10.9	0.30

Source: European Bank for Reconstruction and Development

mania and countries in the Caucasus. When America's treasury secretary, Paul O'Neill, attended the EBRD's annual meeting in Bucharest in May, he made a point of visiting a small furniture factory nearby that had been given a small-business loan.

Even the countries in the first wave of EU accession need more small-business finance. But Peter Felcsuti, managing director at Raiffeisen Bank Hungary, warns against a one-size-fits-all concept for the region: "In Poland, a company with €5m in sales is treated as an SME, whereas in Hungary, because of the competition between banks, even a €2m company can get special service as a corporate borrower."

The EU's Phare programme channels funds into small-business lending via the EBRD and other European financial institutions. Without the right incentives the banks can suddenly pull the plug. The EBRD's programme, which started at the end of last year, opens lines of credit to local banks that sign up. The EU pays for technical assistance. There are grants to help with such things as marketing and training loan officers. The maximum loan is €250,000, and the average around €25,000, but two-thirds of the total number are micro-loans—anything from $50 to $10,000. There is an incentive scheme for the banks: if their portfolio performs well, they get a funding subsidy of 3.4-5.5% from the EU, depending on the size of the loan. "Our biggest concern," says Charlotte Ruhe, who runs the EU-sponsored scheme at the EBRD, "is that the subsidy should not be passed on to the borrower. That would distort competition."

So far the EBRD has signed up 23 banks in the ten accession countries. About €180m has been lent. More important, the average response time for applications from borrowers has come down from a month to five days. The most enthusiastic bank, says Ms Ruhe, is Bank Zachodni WBK in Poland, whose management is committed to the project and has trained loan officers in 300 branches. In the Czech Republic, experts from Shorebank, a small-business bank in the Chicago region, are helping Ceska Sporitelna run its SME lending programme. The bank tried to expand into small-business lending ten years ago, with disastrous results: it had to be bailed out. But under its new owner, Erste Bank of Austria, it is now flush with deposits and trying to broaden its loan portfolio.

Although securing loans is important, "we try not to turn down a loan that is not based on collateral," says Gretta Larson, a Shorebank expert working at Ceska Sporitelna. Recently the Czech Republic amended the law to permit a lien on movable collateral such as machinery and other capital goods. Neighbouring Slovakia has also passed a new law, based on American practice, which from January 2003 will allow machines, cars, furniture and even intellectual property to be used as collateral. That puts it ahead of most European countries using Napoleonic law, says Katarina Mathernova, an adviser to the government.

The European Investment Bank (EIB) also assists small business through its "global" loans. Unlike the EBRD, which adds technical assistance and monitors each project locally, the EIB tends to push out the money from its headquarters in Luxembourg and trust the local banks to run the projects. As a safeguard, it usually chooses banks whose shareholders include the EBRD, the International Finance Corporation (an affiliate of the World Bank) or Kreditanstalt für Wiederaufbau (KfW), or it lends through the central bank, with a sovereign guarantee. KfW also has a programme of its own, which is slightly cheaper than the EBRD's. The EIB undercuts them both.

Think small

When Elizabeth Wallace was working for the EBRD in the early 1990s, she was struck by the wastefulness of closing down big chunks of the communist world's arms industry without helping the newly unemployed to start new businesses. The EBRD's minimum loan in those days was $15m. An out-of-work munitions worker might have needed a loan of $10,000 to start growing mushrooms in the factory where he once made bombs, says Ms Wallace. Another $10,000 could have started a business cutting up redundant battle tanks. Yet none of this was being done.

Against opposition within the EBRD, notably from Ronald Freeman, the vice-president, Ms Wallace—who is now director for small-business finance at the bank—raised $150m from G7 governments to start the Russia Small Business Fund. Pilot projects in Russia were successful. Losses have been minimal: during the 1998 crisis, when the government defaulted on its debt, "we lost some banks [which went bust] but we kept the clients," Ms Wallace says. One good thing about micro-loans is that the mafia, which to varying degrees is active throughout Central and Eastern Europe, is not interested in taking a cut of such small-scale business.

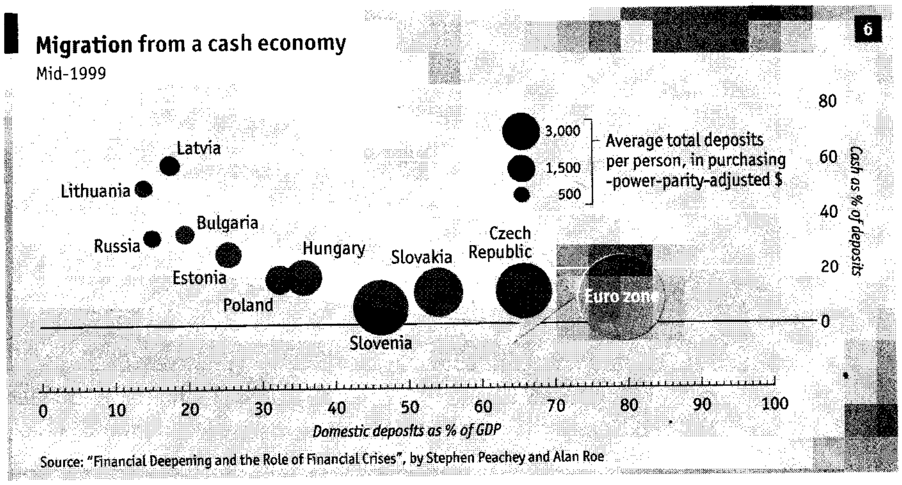
The EBRD's micro-lending programme, which is now well-established, channels lines of credit to local banks specially set up for the purpose. To date the bank has mobilised $500m of small loans to the region. There are micro-lending banks in Albania, Bosnia, Kosovo, Moldova, Russia and some Central Asian countries. The performance of these banks depends almost entirely on the quality of the loan officers, who must identify good potential borrowers, understand their psychology and keep them motivated.

Collateral is the stumbling-block for most small-business lending. What can a borrower pledge when starting from zero? Ms Wallace's team sought advice from the World Bank and from micro-banks in Indonesia, Mozambique and elsewhere, and found that almost anything will serve as collateral, provided it means a lot to the borrower. It could be a cat, a cow or a treasured fur coat, but preferably a house. As long as the borrower is determined to hold on to the collateral, he or she will probably go on servicing the debt. In most countries the arrears rate has been remarkably low, under 1%. Even in Albania, where a pyramid scam hit thousands of people, the arrears amount to only 3.4% (see chart 5, previous page). The Micro-Enterprise Bank in Kosovo is thought to be the most profitable in Central and Eastern Europe.

In the 1990s many international banks were trying to reduce their loan books and concentrate on fee income from corporate finance and the more affluent clients. Now some have decided that they were wrong to neglect retail and small-business lending. That should make life easier for small borrowers like Aniko. ■

Inconspicuous consumption

Suddenly everyone wants to harness the power of consumers. But they are still thin on the ground



PETER KISBENEDEK used to sell insurance. Before that he was in white goods. Perhaps he is just the man to bring a fresh approach to retail banking in Hungary. Austria's Erste Bank must have thought so, because it hired him in 2000 to run its small bank there.

Small, but getting bigger. Erste had bought three small Hungarian banks in the late 1990s and merged them under its own name. At the end of 2000 it had around 1.8% of the retail market. Mr Kisbenedek saw a gap in the provision of mortgages and sold them hard. He is convinced the mortgage market will grow, and Erste Bank with it. By April 2002, Erste reckoned its share of the retail lending market in Hungary had grown to 4.3%.

It also opened lots of new branches on the cheap—ten in Budapest last year, at an average cost of €200,000 a time. Even no-frills Erste used to spend ten times that on opening a full-service branch. Most of the new branches are in shopping malls, where the infrastructure is already in place, and each has a staff of only four, all of them salesmen. Credit decisions and processing are handled centrally. The bank is prepared to close branches that do not work—"like shoe shops", says Mr Kisbenedek. By the end of 2002 Erste plans to have 35 branches in Budapest and other big cities, and will be storming towards the 20-25% share in retail banking and 8% share in small-business lending that it believes it needs to become a force in Hungary. To get there faster, it will probably try to buy another bank.

But the retail market in Hungary is getting cluttered. Even banks that previously had no interest in this particular sector now see the attractions of a sophisticated and increasingly affluent clientele. They include Citibank, Raiffeisen Bank and Central-European International Bank (CIB), which previously concentrated on corporate banking. The retail market is already the stamping-ground of Postabank, Budapest Bank (owned by GE Capital), K&H Bank (owned by KBC) and HVB Bank of Germany, all dominated by OTP, the big savings bank, "like Snow White and the seven dwarves", says a competitor.

Erste is going for a market share of above 20% in several Central European countries. In the Czech Republic and Slovakia it has two sister savings banks, Ceska Sporitelna and Slovenska Sporitelna, which are already market leaders. In Croatia, adding Rijecka Bank to the three banks it has already bought and merged should bring it close to a 10% share. Several other European banks, mainly Austrian and Italian, have similar plans for the region.

This is in marked contrast to European banks' strategies for the euro zone, where cross-border bank mergers have so far been rare. Is there some reason why a retail presence straddling several countries should work better in Central than in Western Europe?

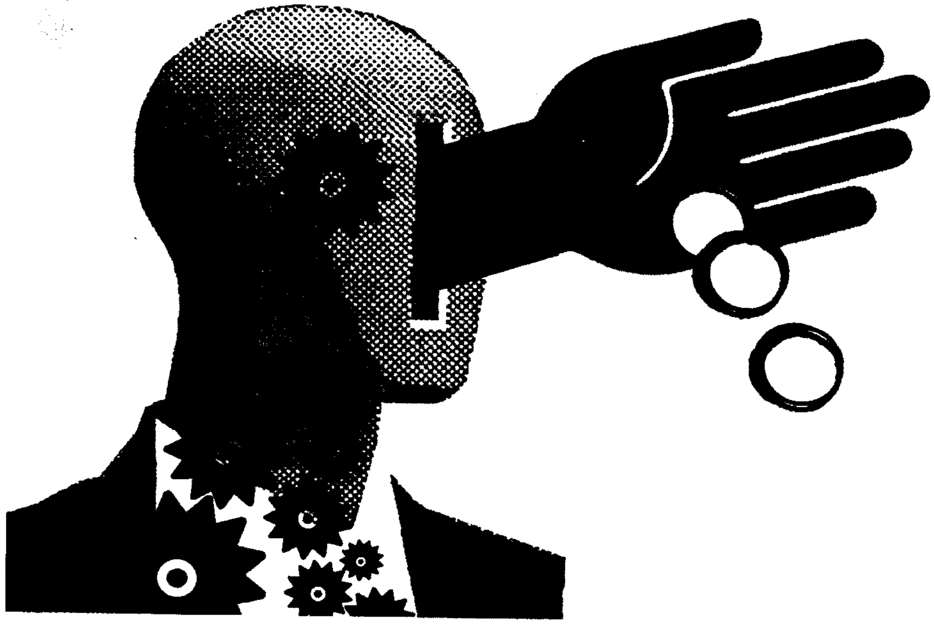
Certainly the market is less mature. For retail financial services, Central Europe is almost virgin territory. Mortgages are only one of the products that have started from scratch. Others include leasing, credit and debit cards, asset management, securities broking, pensions and insurance. Ownership of private property is still underdeveloped in Poland, compared with countries such as America or Britain, says Pierre Mellinger at AIG-CET in Warsaw. The Poles mostly keep their wealth in disposable assets such as cars.

Until that changes, building up capital markets and investment products there will be difficult. Improvements to legal systems and bankruptcy procedures would help, by providing more incentives for private and corporate borrowers to repay their debts. It would unlock chains of inter-company debt, as well as weaning banks off the easy option of keeping big chunks of their balance sheet in (supposedly) risk-free government bonds and encouraging them to take more credit risk. "If small-business lenders are experiencing only 1% of bad debts, it seems to me the banks aren't taking enough risk," says Paul Cunningham, a partner at PricewaterhouseCoopers in Prague.

The banks operating in former Yugoslavia face a special challenge. Companies there have been able to make their payments via a central system called Zop where they keep their accounts. Until Zop is dismantled, it will remain hard for banks to build an account relationship with corporate customers.

Under the mattress

Banks in Croatia, Slovenia, Serbia and a number of other countries had a one-time chance to gain more customers towards the end of 2001, just before the introduction of euro notes and coins, when thousands of accounts were opened to convert D-marks into euros. Much of this money had been sitting in shoe-boxes and under mattresses for years. According to one estimate, a total of €4 billion-8 billion was converted and deposited in Serbian banks, but most of it was whipped out again soon after January 1st. Raiffeisen Bank's three ▸▸



branches in Serbia took around €83m of extra deposits during that period. In Croatia, banking assets reported at the end of the year had grown by 33%, "mainly because of the euro conversion," says Ljubinko Jankov, head of research at the Croatian National Bank.

It is reassuring that there is this extra wealth lurking under mattresses. But in Serbia, for instance, it means that there may be up to €8 billion lying idle and not working for the economy. Foreign-owned banks have been better at making such one-time deposits stick. Raiffeisen suffered no net outflows, and attracted more deposits until the May 31st deadline.

A study by the EBRD on bank reform, looking at 515 banks in 16 transition countries, shows that reform does not necessarily increase lending to customers. Often the government bond market takes precedence, crowding out private borrowers.

In the Czech Republic, Slovakia, Hungary, Bulgaria and Macedonia, the ratio of domestic credit to GDP is between 68% and 103%. Everywhere bar Slovakia, it is well below the ratio found in other market economies at a comparable stage of development. Worryingly, in Poland, Croatia and even the highly westernised Slovenia the ratio is below 40%. At the present rate of asset growth, it would take Poland 141 years to reach a level appropriate for a market economy, according to the EBRD.

The study suggests that foreign-owned banks are no better at beefing up their loan books than state-owned banks or locally owned private banks, but their cost-effectiveness and productivity are higher. In general the presence of foreign banks, or banks with strategic foreign partners, appears to have increased competition and brought down charges.

Looking ahead

In another ten years, the banks that are beginning to dominate the region will probably have been acquired by larger international financial groups like Citigroup, Société Générale or Goldman Sachs—perhaps even Axa or Aviva. By that time, most Central European countries will be using the euro and will have become part of a vast financial market akin to that of the United States. There will be continent-wide brands of consumer finance and also, with luck, sources of finance for local small business. Shares in the major companies will trade only in the big centres, such as London, Paris and Frankfurt, but many more people in Central Europe will take their savings out from under the mattress and put them to work in the financial markets, whether in bonds, shares, private pensions or mutual funds. Their countries will be striving for better corporate governance, more transparency in politics, commerce and the law, and sounder regulation. The cities of Prague, Warsaw and Budapest will have taken their place beside Paris, Vienna and Berlin.

But things could still go wrong here and there. There is the election in Slovakia on September 20th and 21st, which probably won't, but could, put Vladimir Meciar back in office, throwing doubt on Slovakia's membership of NATO and the EU. There is the unresolved dispute between the Czech Republic and Germany over the expulsion of Sudeten Germans from Bohemia in 1945. And there are the shifting Balkans, where ethnic feuds are not necessarily dead and buried.

Existing or incoming governments in Central Europe could reject the conditions for EU entry, which would take the accession process off course. And even once the new countries are in, EU membership may not prove the panacea they had hoped for. An EU and a eurozone enlarged by perhaps ten members will be even more unwieldy and less sensitive to national priorities. There could be strains that encourage thoughts of a voluntary exit, or the expulsion of an errant government if other sanctions do not work. No one has yet dared write that into a treaty but, with 20-plus members, the time may come.

The biggest change required in the transition countries of Central Europe is in people's attitudes of mind, and that will take time. Silviu Brucan, one of Romania's great survivors—a former adviser to the dictator Nicolae Ceausescu, but no poodle—in 1989 told *Le Figaro*, a French newspaper, that it would take 20 years for Romanians to learn about democracy. "I was sued for offending the dignity of the Romanian nation," he recalls, "but now they say I was an optimist." ■

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